SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

October Term, 1966

No. 1214

STRATHMORE SECURITIES, INC. and
AULDUS H. TURNER, JR.,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered on January 3, 1967, affirming *per curiam* and without opinion the order of the Securities and Exchange Commission against the Petitioners.

Opinions Below

There was no opinion in the Court of Appeals. The findings, opinion and order of the Securities and Exchange Commission are set forth at pages 256-268 of the Joint Appendix, nine copies of which are filed with this Court. The decision of the Board of Governors is set forth at pages 251-255 of the Joint Appendix.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on January 3, 1967 (Appendix A, p. 26, *infra*). Jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

Questions Presented

1. Did the procedures accorded to petitioners at the hearings before the District Business Conduct Committee and the Board of Governors of the National Association of Securities Dealers, Inc. (NASD), together with the procedures available to petitioners upon application to the Securities and Exchange Commission for review of the disciplinary action taken by the NASD, operate to deprive petitioners of due process of law as required by the Constitution of the United States, or of a fair and orderly procedure as required by Section 15A(b)(10) of the Securities Exchange Act of 1934?

2. Are the Rules of the NASD as applied to petitioners void for failure to set forth suitable standards with respect to mark-ups to be charged by members in retail transactions?

3. In view of all of the relevant facts and circumstances, was the Securities and Exchange Commission correct in computing mark-ups with respect to securities sold by petitioner Strathmore Securities, Inc. on the basis of contemporaneous purchase prices paid by that petitioner for the securities in issue?

4. Were the findings of the Securities and Exchange Commission that petitioners violated Sections 1 and 4 of Article III of the NASD's Rules of Fair Practice by excessive mark-ups supported by substantial evidence in the record?

Constitutional Provisions, Statutes and Rules Involved

Constitution of the United States, Fifth Amendment:

"No person shall be * * * deprived of life, liberty, or property, without due process of law; * * *"

The relevant provisions of the Securities Act of 1934, 52 Stat. 1070, 15 U. S. C. A. 15A(b)(7), *et seq.*, are set forth in Appendix B, *infra*, pp. 27-33.

Relevant Rules of Fair Practice are also set forth in Appendix B, *infra*, pp. 32, 33.

Statement

A Complaint was filed on May 16, 1963, by the District Business Conduct Committee of District No. 11 (hereinafter called the "Committee") of the National Association of Securities Dealers, Inc. (hereinafter called the "Association"), against Strathmore Securities, Inc. (hereinafter called "Strathmore") and Auldus H. Turner, Jr. (hereinafter called "Turner") and Charles E. Klein, the firm's then president, and various registered representatives employed by Strathmore. Charles E. Klein died on February 15, 1964. The Complaint alleged violations of Article III, Sections 1 and 4, of the Association's Rules of Fair Practice. A hearing was conducted at Pittsburgh, Pennsylvania, on September 19, 1963, before a Subcommittee of the Committee, Charles E. Klein and Turner appeared on their own behalf and in behalf of Strathmore, and all respondents were represented by Counsel James T. Glavin.

On July 29, 1964, a Decision was rendered by the Committee, finding that Strathmore and other respondents had violated Article III, Sections 1 and 4, of the Association's Rules of Fair Practice. The Committee, pursuant to the provisions of Article V of the Rules of Fair Practice, im-

posed penalties fining Strathmore $1,000 and expelling it from membership in the Association, fining Turner $1,000 and revoking his registration as a representative, and fining each of the other respondents $200 and suspending their registration as representatives for 30 days. In addition to these penalties, Strathmore and Turner were jointly and severally assessed $298.05 to cover the costs of the transcript of the hearing.

Pursuant to Section 14(a) of the Code of Procedure of the Association, Strathmore, Turner and the other respondents made application to the Board of Governors (hereinafter called the "Board") of the Association for a review of the disciplinary action and penalties thus imposed. A hearing was held before a Subcommittee of the Board on October 23, 1964. The respondents were represented by Counsel Joseph S. Schuchert, Jr. The record of these proceedings discloses a review of the factual background involved in the transactions upon which the disciplinary action was taken. Counsel for these petitioners also entered objections on the record, raising the question of denial of due process by the Association in the conduct of the proceedings before the Committee. This objection was directed to the procedures and machinery of the Association for the handling of disciplinary matters, and has as its premise, the proposition that the standards and procedures provided in the Rules of Fair Practice and Code of Procedure of the Association operated to substantially deny petitioners that fundamental fairness necessary to meet the minimal requirements of due process.

The Board rendered a decision, in effect, affirming the Decision and penalties imposed by the Committee as to Strathmore and Turner. The Board, however, reversed the Committee as to each of the respondent representatives.

Thereafter, upon an application for review, the Securities and Exchange Commission ("Commission") affirmed the findings of the Board, but reduced sanctions imposed upon Strathmore and Turner to suspensions of 90-days respectively.

Reasons for Granting the Writ

Serious questions of doubt have recently been raised by the Securities and Exchange Commission ("Commission") itself with respect to the issues herein involved. This comes about through the lengthy and intensive investigation by the Commission of standards, measures of costs and other practices involving dealers and firms doing an over-the-counter business and the resulting far-reaching Special Study Report of Securities Markets of the Securities and Exchange Commission.[1] Much of its language is illuminating and relevant to the issues here, as will be readily seen from the following excerpts, pages 652 and 648 of that Report.

The Report states on page 652:

> "One of the difficulties with the present approach of the NASD to the noncompetitive market situation is that it may result in using one base for the reputable firm and another for the marginal firm without any articulated basis for the distinction in the markup policy itself and without coming to grips with the question of what standards are to be applied in judging the fairness of retail prices where there is no independent market.
>
> *"The result of these varying views and interpretations is that many dealers and local NASD district committees apparently do not understand the markup policy."* (Italics supplied.)

and as further demonstration of the absence of standards, on page 648, states:

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[1]Report of Special Study of Securities markets of the Securities and Exchange Commission, H. Doc. No. 95, Pt2, 88th Cong., 1st Sess., pages 649-652 (1963).

> "* * * *However, the NASD has not set forth standards for determining reasonable costs nor has it made a cost study to determine what are reasonable costs for the multiplicity of firms doing an over-the-counter business.*" (Italics supplied.)

By reason of the foregoing language, as well as other extremely material findings of the Special Study Report which are hereinafter quoted and referred to, the petitioners respectfully submit that a comprehensive review by this Court of the important questions raised and indicated in the Report and in this petition is both timely and necessary in this important area of the national securities business and particularly the over-the-counter area involved here.

I. Denial of Due Process and Absence of Standards.

The Association was organized pursuant to the provisions of Section 15A of the Securities Exchange Act of 1934. Section 15A(b)(7) provides that an applicant association shall not be registered as a national securities association unless it appears to the Commission that the rules of the association are designed to prevent fraudulent and manipulative actions and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or rates of commission or other charges, and, in general, to protect investors and the public interest.

Section 15A(b)(8) requires that the rules of the association provide that its members shall be appropriately disciplined by expulsion, suspension, fine, censure or any other fitting penalty for violation of its rules.

Section 15A(b)(9), however, imposes the requirement that the rules of the association must provide a *fair and orderly procedure with respect to the disciplining* of mem-

bers and that in any proceeding to determine whether any member shall be disciplined, such rules shall require that specific charges be brought; that such member shall be notified of, and given an opportunity to defend against, such charges.

The Code of Procedure of the Association provides that any district business conduct committee may file a complaint against a member either with itself, or with any other such committee. *NASD Rules of Practice,* Article IV, Section 3.

If the Committee concludes that a violation has occurred, its decision must include a statement of acts improperly committed or omitted and of the specific rule found to have been violated. *NASD Code of Procedure,* Section V.

The final action of the Committee either for or against the petitioner is subject to review by the Board of the Association. The Board, after notice and opportunity for hearing on the basis of the record before the Committee, "and such other evidence as it may deem relevant" has power to affirm, modify or reverse the decision.

Under Section 15A(g) of the statute itself, any final decision of the Board is in turn reviewable by the Commission. Although the Commission's review may be based upon consideration of the record before the Association "and such other evidence as it may deem relevant," the Commission has stated in general it will not receive further evidence "except in a case where it is shown that evidence is relevant to the issues raised but could not be presented in the original proceedings" before the NASD: *Herrick, Waddell & Co., Inc.,* 23 S. E. C. 301, 303 (1946); *Gerald M. Greenberg,* Sec. Ex. Act. Rel. 6140 (1959). This rule is now codified in Rule 15(a)(g)—(1)(d).

Final disciplinary action imposing a penalty of expulsion against a member, for all practical purposes, operates as an economic sanction of such severity that the disciplined securities firm can no longer continue in business. The rules of the Association do make it "virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of important size." *National Association of Securities Dealers, Inc.*, 19 S. E. C. 424, 441 (1945). For the rules of the Association not only require members to treat non-member brokers and dealers the way they do members of the public, but also forbid members to "join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof." *NASD Rules of Fair Practice*, Article III, Section 25.

Of course, the legislature contemplated this effect in adopting the enabling statute. The legislative reports paraphrase Section 15A(i) of the Act and go on to say:

> "Thus, it is contemplated that exclusion from membership in a registered securities association will be attended and implemented by economic sanctions. In this respect, exclusion from such association would be comparable in effect to expulsion from a national securities exchange." *S. Rep. No.* 1455, at S-9 and *H. Rep. No.* 2307 at 9, 75th Cong., 3d Sess. (1938).

Therefore, if a member of the Association is expelled on the basis of disciplinary proceedings conducted under the Code of Procedure of the Association, he is, in effect, surely being deprived of a substantial property right; *i.e.*, the ability to continue in business as a securities broker or dealer. The severity of this sanction therefore makes it particularly necessary to ensure that in the conduct of disciplinary proceedings, all of the concepts of fundamental fairness attendant to due process be strictly observed.

Of course, in any "disciplinary" action instituted by the Commission itself in the nature of revocation proceedings, the applicable statute and regulations set forth a strict procedure for the hearing and determination of the matters at issue. Petitioners are given notice and opportunity to be heard; the right to be represented by counsel; subpoena power is available in order to obtain evidence and testimony of material witnesses; testimony is taken under oath; and in accordance with the requirements of the Administrative Procedure Act governing administrative agencies of the Federal Government, there must be an effective separation of prosecution and judicial functions.

In sharp contrast to these fundamental safeguards afforded in administrative proceedings instituted by the Commission, is the procedure in disciplinary actions under the Association's Code of Procedure. Although a petitioner is given notice and opportunity to be heard and the right to be represented by counsel, all of the other fundamental practices which are indeed required under the Administrative Procedure Act are absent. Testimony is adduced by the Committee usually through its secretary who presents to the Committee a summary of information obtained and prepared by staff investigators employed by the Association. These investigators are normally unavailable at the hearing so that a respondent has no opportunity to cross examine the person who originally investigated and prepared the information in support of the complaint. Certainly, this was the situation in the present proceedings. Mr. Doyle appeared in behalf of the Committee and presented a summary of information which had originally been obtained and prepared by other persons. Apparently, based upon other experiences in similar actions before the Committee, this is the procedure which is always

followed. Furthermore, a respondent has no subpoena power to obtain vital and material information and testimony. Many times, particularly in mark-up violation cases, actual transactions by other brokers in the same stock are the only real evidence of independent market. Although the Committee has free access to the books and records of all other member firms in conducting its investigation, a respondent firm is wholly without the ability to formally obtain material information from the same or other member firms. At most, a respondent may solicit the cooperation of other member firms to voluntarily furnish such information, but this has proved unsuccessful because of the inclination of such firms to shy away from another member in trouble, and to avoid involvement in proceedings before the Committee.

The testimony which is presented before the Committee is adduced without any oath or other affirmation; in other words, the testimony and any documentary evidence connected therewith comes in without the benefit of oath and is completely unsworn. The salutary effect of an oath upon a witness' truthful statement of facts has been so long and cogently demonstrated in our judicial process as to require no further argument.

Next, the same Committee which causes or participates in the investigation of matters involved in a potential complaint, and which in fact prepares and files the complaint after *ex parte* consideration of facts disclosed in its investigation, actually sits in judgment of the respondents in the proceedings themselves. Members of the Committee are local competitors of the petitioners in the securities business.

The Association, in all respects, is indeed a quasi-administrative agency. It was organized pursuant to the

Securities Exchange Act of 1934 as a self-governing national securities association. Its disciplinary procedures are reviewable by the Commission and thereafter by the courts. The enabling act under which it was created also required that in any disciplinary action, a fair and orderly procedure must be followed. The Association cannot be considered as other associations in the nature of private clubs or labor unions which have the right to establish their own rules and regulations concerning the disciplining of members. Loss of membership in the Association is tantamount to the loss of right to engage in the securities business. In this regard, the Association may be likened to a public institution. The House Committee Report commenting on exchange disciplining and rules observed: "The bill proceeds on the theory that the exchanges are public institutions * * * and are not private clubs to be conducted only in accordance with the interest of their members." *H. Rep. No. 1383,* 73d Cong., 2d Sess. (1934) 15.

Being therefore a quasi-administrative body whose rules must be approved by the Commission, and whose proceedings are reviewable by the Commission, and thereafter by the courts, the Association must provide in disciplinary proceedings the same minimal guarantees of procedural and substantive due process that are required of the Commission or any other administrative agency.

The basic disciplinary machinery of the Association, therefore, is constitutionally deficient. Although the absence, for example, of subpoena power alone may not in itself so substantially impair a respondent's rights as to constitute a denial of due process cognizable by the courts, the combination and total effect of all of the deficiencies referred to above is overwhelming.

Although the Commission theoretically has the power to review the disciplinary proceedings *de novo,* the review is based on the record below and such other evidence as it may deem relevant. However, since the record below is the product of a procedure wholly devoid of basic and fundamental safeguards of due process, fair and effective review by the Commission is rendered impossible.

> "The cardinal test of the presence or absence of due process in an administrative proceeding is the presence or absence of rudiments of fair play long known to the law * * *" 16 A C. J. S. Sec. 628, page 851.

If an administrative decision "constitutes an arbitrary, discriminatory or unreasonable interference with personal or property rights, it is void as in violation of the due process provisions of the Constitution, and administrative convenience or even necessity cannot override constitutional requirements of due process." *Cella v. U. S.,* 208 F. 2d 783, cert. den. 74 S. Ct. 864, 347 U. S. 1016, 98 L. Ed. 1138, and see *Ohio Bell Telephone Co. v. Public Utilities Commission of Ohio,* 301 U. S. 292; 57 S. Ct. 724.

Due process of law is further denied the petitioners in these proceedings, and indeed in all of the Association's disciplinary proceedings involving mark-up, because of the absence of any standards in the rules of the Association governing mark-up. Obviously, the so-called "5% policy" is not a policy which is understood or consistently applied by the Association itself.

What has occurred here with respect to the mark-up policy is that the Association has adopted a rule of fair practice which constitutes a generally stated policy, devoid of any reasonable standards upon which a member firm may predicate a judgment as to any particular security or transaction. A reading of the entire Special Study Report

concerning NASD mark-up policy convincingly demonstrates the chaos and absolute misunderstanding which exists in this area. The reason, of course, is that no standards were ever adopted by the Association as a part of its Rules of Fair Practice.

The expulsion or suspension of a member firm for violation of a policy which is confused, misinterpreted and devoid of standards results from an arbitrary and unconstitutional delegation of power to the Association, which therefore, impairs and denies due process of law to a disciplined member. Numerous cases could be cited which articulate in general the requirement of fundamental fairness in a proceeding in order to afford due process of law under the Constitution. There is no necessity for a repetition of such authorities although it is true that no case has been found with a factual situation substantially analogous to the present.

It is respectfully submitted that the procedural machinery of the Association itself is incapable of affording a respondent due process of law in disciplinary proceedings. As a quasi-administrative body, the Association should be required to comport with the same rudiments of fair play and afford the same basic protections as are required of administrative agencies. The absence of these safeguards as outlined above renders any proceeding conducted by the Association, and any penalty invoked as a result, null and void. For these reasons, it is requested that the decision and penalties imposed by the Association, the Securities and Exchange Commission, and the Court below, be reversed.

II. Mark-up Charges and Policy.

Cause (a) of the Complaint alleged that the Petitioner Strathmore and individual petitioners engaged in the practice of selling securities to customers at prices which were not fair in view of all of the relevant circumstances. It was charged that each of 88 transactions on two schedules which were attached to the Complaint constitute separate and distinct violations of Article III, Sections 1 and 4, of the Association's Rules of Fair Practice.

Unison Electronics Corporation. The first schedule listed 52 transactions in the common stock of Unison Electronics Corporation (hereinafter called "Unison") which were all transactions with members of the public during the period of February 7, 1963 to February 26, 1963. Since the decision of the Commission does not contain any findings with respect to factual matters involved, it must be assumed for purposes of this petition that the Commission has, in effect, adopted the findings of the Board.

Admittedly, Strathmore, during the period in question, was the only dealer appearing in the "pink sheets" of the National Quotations Bureau, Inc. with a quotation in the stock. This quotation was consistently 1⅝ bid, 1⅞ asked. Strathmore's practice was to buy at the bid price and sell at the asked price which it listed in the "pink sheets." Further, it is uncontested that on February 18, 1963, Strathmore purchased 8,340 shares from another dealer at 90 cents a share, and while it did not change its quotation in the "pink sheets," the following day it began selling shares to the public at its bid price of 1⅝.

The Decision of the Committee arbitrarily concluded that on the transactions where Strathmore purchased at a bid price of 1⅝ and sold at the asked price of 1⅞, in

accordance with its "pink sheet" quotations, it realized a "mark-up" of 15%, which was not consistent with fair and equitable principles of the trade. As to the transactions involving the purchase of 8,340 shares at 90 cents a share and their subsequent resale at Strathmore's bid price of 1⅝, the Decision found a mark-up of 81%. No serious consideration was given by the Committee to all of the relevant facts and circumstances surrounding the purchase of the 8,340 shares and their subsequent sale. A review of the record of the proceedings by the Subcommittee of the Board on October 23, 1964, would indicate that there were many factors which were not considered or were ignored by both the Committee Board and the Commission in their respective decisions. For the purposes of this brief, reference to the record shall relate to the record of proceedings before the Board.

The record definitely establishes that Strathmore is an "integrated" securities firm whose activities over the past seven years have consisted of making a primary market as well as retailing stocks of six or seven companies. Frequently, Strathmore had acted as either the underwriter or member of the selling group in the offering of shares of such companies. This was certainly true in the case of Unison, Strathmore's role then was that of an underwriter, dealer and a retail firm.

In the case of Unison, Strathmore had been a member of the selling group in a Regulation "A" offering of 100,000 shares at 1¼. Upon completion of the offering, Strathmore made a market in the shares and conducted a retail sale of shares to its customers. Since the company was unseasoned, there was no other dealer interest in the stock except that the underwriter, Gateway Stock & Bond, Inc. (hereinafter called "Gateway"), continued to make a

market in the stock, although it did not consistently insert its quotations in the "pink sheets" (R. 72, 73). However, after the stock had been on the market for a time and the company appeared somewhat more seasoned, there was other dealer activity in the stock beginning about September 1964 at prices of 1⅜ bid, 1⅝ asked (R. 33). These transactions involved sales to member firms of the New York Stock Exchange. Turner and Strathmore were aware of the fact that Gateway was continuing to make a market in the stock at approximately the same price level as Strathmore's, and hence, were fully aware, as was the Association, that there was another independent market in the stock.

The Commission has taken a position which either ignores or fails to comprehend the difference between a "spread" and a "mark-up" and which totally disregards the common situation where an integrated firm is either the principal or sole market in an unseasoned security. The Decision arbitrarily concludes that contemporaneous cost be used as the basis for a mark-up determination. Although the record does not disclose any inter-dealer sales by Strathmore to Gateway during the period in question, the evidence adduced supports the fact that Gateway, as the underwriter of the stock, continued to make a market in the security at approximately the same levels as Strathmore. But the record does establish a sale by Gateway to Strathmore on February 20, 1963, of 1000 shares. In an unseasoned security which had recently been the subject of a Regulation "A" offering, it would certainly be unreasonable to expect any substantial dealer participation.

The Decision of the Board as affirmed by the Commission and the Court, therefore, effectively precludes an under-

writer or selling group member from maintaining an orderly market in an unseasoned security for the benefit of customers who had purchased in the offering, since it would require retail sales by such firm at prices lower than those which it must stand ready to sell to other dealers. The absence of substantial outside dealer activity does not decrease the risk involved to a firm who wishes to make a market in such stock, but would rather have the opposite effect, and, such a firm electing to make an orderly market, and to assume a substantial risk position, would be limited to approximately the same profit on the transactions as a dealer effecting an agency trade in a riskless transaction.

It was never intended that the mark-up policy be distorted in this manner. The record clearly establishes that Strathmore was continually in a risk position in trading the shares of Unison and sold to retail customers at its offering price which was the same price it stood ready to effect transactions with other dealers. Considering the limited net worth of Strathmore at the time of these transactions, its activity in making an orderly market for its customers unquestionably exposed it to substantial risks.

The misapplication of the mark-up policy in situations similar to the instant case is best summarized in the Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part II, and excerpts from that Report on page 649 through 652 so illustrate:

> "Where the dealer is at risk, *i.e.*, has a position in the security, the proper base for computing the markup is not as clear. Is the markup to be computed from the integrated firm's contemporaneous costs, *i.e.*, its inside bid, or from a representative offer of another wholesale dealer appearing in the sheets? An integrated firm making a market in a security by placing two-way quotations in the sheets ordinarily will purchase stock at

its inside bid. If the fairness of the markup is based on the integrated firm's contemporaneous cost, the markup would be computed on the basis of its bid price. In the case of many low priced securities, where the spread between the inside bid and offer may be considerably more than 5 percent, the integrated firm might then have to sell to its customers at a price less than its inside offer, *i.e.*, the price at which it stands ready to sell to other broker-dealers. 'On the other hand, if the markup is computed on the basis of a representative offer appearing in the sheets, sales will be made at a price considerably in excess of 5 percent of the integrated firm's contemporaneous cost.

'Most integrated firms follow the practice of basing their markup on their own inside offer. The reason for using the dealer's offer rather than its bid as the base for computing the markup was stated in this way to the study by the then chairman of the board of governors of the NASD:

> 'As I look at a transaction involving both a retail sale and a position, I think of it, in effect, as reflecting two functions. One is the retail function. For this, I think the dealer is entitled to a profit equivalent to the profit he would derive if he were not in position * * * (A)ny profit that he earns as a result of being in position, and at risk, is a separate profit, to which he is entitled by virtue of his willingness to assume the risk.
>
> 'The two charges are added so that in a wholesale market of 9½ bid, 10 asked, the dealer's public customer may pay 10½, reflecting a 5-percent markup over the inside over.'

* * *

"Despite the position taken by the NASD before the Commission on the use of contemporaneous cost, there now appears to be some doubts among NASD officials as to its use in situations where a firm is at risk. Some NASD officials apparently now take the position that contemporaneous cost is not the proper basis from which to compute the markup, if the dealer is at risk

and there is an independent market. Counsel for the NASD, in referring to the use of contemporaneous cost, stated:

'Now, I would be inclined to think that, with the emphasis on contemporaneous cost in the early days of 5 years ago, that, probably members have been censured where we did not review it or there was not an appeal to the board. * * * My impression of what happened up to 1959, I gained from what I began to see in cases being decided in 1958, when I came with the association. I think that the stress was put, in cases there, on contemporaneous cost.

* * *

'What we saw at the board level was what appeared to be an overemphasis on contemporaneous cost at a basis for computing markups, and in cases that we began to review and hear on appeal, we found there was another whole argument to be considered before we made a determination.

* * *

'It appeared to me there was not a sufficient enough emphasis, in view of the thinking of the board that I became acquainted with, there was not sufficient emphasis put on the independent offer.'

"A former chairman of the NASD board of governors indicated to the study that contemporaneous cost is applied only in riskless transactions. He testified as follows:

'Q. Now, let us assume that, in making a market, that the firm buys 400 or 500 shares and sells 400 or 500 shares and never accumulates a significant amount of shares or dollars. Would your answer still be the same with respect to whether you used the contemporaneous cost or independenet offer?

'A. Generally speaking, I would say yes.

'Q. So the contemporaneous cost is only used, in effect, to riskless transactions. Is that what it comes down to?

'A. That is what it boils down to; yes.'

"A past member of the NASD board of governors has indicated that the transaction would not be risk-

less even though the dealer's postion was only transitory:

> ' * * * (I)f he (the dealer) has no order at the time he bought it from his retail accounts, whether he got an order 2 hours later or whether he waited for the rest of the day, into the next day, and accumulated 500 shares, as far as I am concerned, he is at risk.'

"This position has been confirmed by the recently deceased chairman of the board of governors.

* * *

"The important change in emphasis from contemporaneous cost to the independent offer has apparently not been recognized by all of those responsible for the administration and enforcement of the markup policy. Some NASD examiners in policing compliance with the markup policy contemporaneous cost whether or not the firm is 'at risk'. And some NASD district committees in disciplinary proceedings continue to use contemporaneous cost in situations where the independent offer, according to the statements of NASD officials set forth above, is the proper basis for computing the markup.

"There is another difficult area of interpretation which emerges from NASD enforcement of the markup policy and which is not explicitly recognized or distinguished either in the policy itself or in the cases. As noted earlier, there are many securities or limited activity in the over-the-counter markets where market may be confined to one or two dealers at most and for which there is no independent competitive market. Often these securities are inactive and the consequent risks involved in taking positions may involve dealer spreads considerably in excess of 5 percent. If contemporaneous cost was used as a base for computing the markup, the dilemma described earlier would arise —the firm might have to sell to its customers at a price less than the price at which it stands ready to sell to dealers, thus making normal dealer activities impossible. On the other hand, since the market is a noncompetitive one, the use of the inside offer as the base for computing the markup may be unsatisfactory, particu-

larly if the firm is engaged in a retail selling campaign where its own inside quoted prices provide the basis for retail prices.

"In enforcing the markup policy, the NASD has taken the position that, if there is no independent market, contemporaneous cost should be used. This is apparently based on the premise that, if a dealer is in a position to establish the price level through its own retail selling its inside offer is not a valid basis for computing markups. Carried to its logical conclusion, the application of the markup policy in this manner might, if applied uniformly, tend to reduce appreciably the availability of markets for low-priced securities having limited dealer interest. On the other hand, to ignore the fact that there is no independent market may be to permit markups on an artificial base. One of the difficulties with the present approach of the NASD to the noncompetitive market situation is that it may result in using one base for the reputable firm and another for the marginal firm without any articulated basis for the distinction in the markup policy itself and without coming to grips with the question of what standards are to be applied in judging the fairness of retail prices where there is no independent market.

"The result of those varying views and interpretations is that many dealers and local NASD district committees apparently do not understand the markup policy."

Strathmore, as an integrated securities firm and member of the selling group of the Regulation "A" offering of Unison, made a market in the stock of the company and inserted its quotations in the "pink sheets." It stood ready to effect transactions with other dealers at the prices so quoted. It was continuously in a risk position in that it maintained either a substantial long or short position in the stock relative to its net worth. It was aware of at least one other market in the stock at the same levels being made by the original underwriter. Later, other dealer activity initiated in the stock at approximately the same spread.

Strathmore and Turner took considerable interest in the company and spent substantial time and money in reorganizing the company, and assisted in its direction into other more diversified business fields. The difference between the bid and the asked price represented Strathmore's spread in the security and cannot be considered as a mark-up under any reasonable interpretations of the "mark-up policy." It is apparent from the foregoing excerpts from the Special Study Report of the Securities and Exchange Commission that the mark-up policy is misunderstood by the Association itself, and has been frequently misapplied in disciplinary proceedings. The Special Study further points out that the Association has failed to come to grips with the problem of sufficiently defining the policy so that it can be reasonably understood by dealers who earnestly wish to comport with fair and equitable trade practices. In the case at hand, the petitioner did not violate the Rules of Fair Practice with respect to excessive mark-ups on the normal trading conducted in Unison, and it is submitted the evidence so shows.

III. Other Conclusions not Supported by the Evidence.

Several other conclusions arrived at in the Decision of the Committee were apparently based on no evidence at all or on the supposition of the Committee members. For example, the Decision states that the petitioners "are engaged almost exclusively in the sale of low priced over-the-counter speculative securities to members of the public by means of telephone solicitations." On the contrary, in the latter part of 1961 and 1962, and during the first part of 1963, the biggest volume of Strathmore occurred in stocks having prices of more than $10 per share. During the latter part of 1961 and for most of 1962, the biggest part of Strath-

more's volume occurred in stocks having prices of more than $15 per share.

The Decision also stated with respect to the sale of Unison stock, "We also question the risk involved at 1⅞ where there is a known source of shares at $1.00." Such a conclusion simply is not true. There was no definitely known source of shares at $1 until February 15, 1963, after the close of business, and these shares were only purchased on February 18, 1963, the first business day thereafter. No sales were made at the price of 1⅞ after the block of 8340 shares was either known to be available at $1 or was purchased by Strathmore at 90 cents.

The Decision states that this is the third time that Turner has been before the Committee and "We believe he has been given every opportunity to change his ways." The facts are that Turner was secretary of Kettering-Frankel, a member of the Association, and joined that firm as an officer after having been engaged in the securities business four or five months as a salesman. Kettering and Frankel were the principals of this firm and handled all trading and back office work. Turner was only a salesman for this firm although he had occupied the position of secretary. Turner had no control and set no buying or selling policy at the firm at that time.

Strathmore began business in June of 1959. A complaint based on excessive mark-ups was filed by the Association in August of 1959 and after a hearing held in December of 1959, the firm was fined $2,000. This mark-up complaint related to a stock traded by between 15 to 25 brokers, all of whom submitted quotations in the "pink sheets." Strathmore's misconduct was, in effect, that they used the same pricing policy, as the other brokers. Strathmore had been in business for only about two months and had very little

opportunity to become experienced in the customs and usage of the trade.

Conclusion

The basic conclusions of the Decision rest on false foundations and erroneous and improper applications of the mark-up policy. The Association has indeed itself recognized the need for active small brokers engaged in a diversified securities business of underwriting, trading and retailing. The Board of Governors of the Association has expressed certain views in its bulletin of October 21, 1964, which are pertinent here:

> "There are many factors which distinguish the over-the-counter market from an Exchange market. Most broker dealers who operated in the over-the-counter market regard themselves as engaging in merchandising operations. It is in this market that all new corporations seek to raise capital from the public which is first introduced to the investor and the markets for securities in most small corporations as well as a good many larger corporations are maintained after initial distribution.
>
> "The degree of effort, time and corresponding costs involved in seeking buyers and sellers and explaining the merits of these particular securities are generally greater than that required when dealing in a listed security.
>
> "The cost involved is such that in the case of many broker dealers this function could not be properly performed at a Stock Exchange commission. Consequently, there would be no incentive to generate investor interest in securities of lesser known companies.
>
> "These dealers, although small in size, have always been regarded as an essential part of the nation's securities distribution system, with the functions of underwriting the securities of small corporations and of merchandising securities of local companies."

The bulletin goes on to say that there is no basis for any assurance that the larger firms will take up the functions traditionally performed by smaller broker dealers.

Strathmore's position on this matter as far as a factual defense is concerned is founded fundamentally on the proposition that the difference between the bid and asked prices which generally governed its purchases and sales, was not a mark-up, but a spread. Strathmore was truly concerned with maintaining, as an integrated securities firm, an orderly market in the securities involved. Strathmore's obligation, it would seem, at least its moral obligation, was to maintain, on a fair and orderly basis, a market for the securities of customers who purchased from it in retail transactions. Particularly, this was so in securities where the firm had acted as an underwriter or member of a selling group in a distribution.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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MAURICE J. MAHONEY,
Counsel for Petitioners.

1420 Frick Building,
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March 1967.

Appendix A

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,175 September Term, 1966

STRATHMORE SECURITIES, INC., and
AULDUS H. TURNER, JR.,
Petitioners.

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Petition for Review of Order of the Securities and Exchange Commission.

Before: Burger, Wright and Robinson, Circuit Judges.

JUDGMENT

Filed January 3, 1967.

This case came on to be heard on the record from the Securities and Exhange Commission, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is ordered and adjudged by this court that the order of the Securities and Exchange Commission on review in this case is hereby affirmed.

PER CURIAM,

NATHAN J. PAULSON,
Clerk.

Dated: January 3, 1967.

Appendix B

STATUTE AND RULES INVOLVED

SECURITIES EXCHANGE ACT OF 1934
SEC. 15A

* * *

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

* * *

(8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining

of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include—

(A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member or other person may be found to have omitted.

(B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation.

(C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade.

(D) a statement setting forth the penalty imposed.

In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for

denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based.

* * *

(g) If any registered securities association (whether national or affiliated) takes any disciplinary action against any member thereof or any person associated with such a member or denies admission to any broker or dealer seeking membership therein, or bars any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), unless the Commission otherwise orders after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral argument).[1]

(h)(1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant—

(A) finds that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and

(B) determines that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association,

the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A), or if the Commission determines that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

(3) In any proceeding to review the denial of membership in a registered securities association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, determines that the specific grounds on which such denial or bar is based exist in fact and are valid under this section,

the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member.[1]

COURT REVIEW OF ORDERS

SECTION 25. (a) Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such person is a party may obtain a review of such order in the Court of Appeals[1] of the United States, within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia,[2] by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, and enforce or set aside such order, in whole or in part.[3] No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in

the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, and enforcing or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

RULE 15Ag-1. APPLICATION PURSUANT TO SECTION 15Ag-(g) OF THE ACT FOR REVIEW OF DISCIPLINARY ACTION OR DENIAL OF MEMBERSHIP BY A REGISTERED SECURITIES ASSOCIATION

(*e*) On its own motion, the Commission may direct that the record under review be supplemented with such additional evidence as it may deem relevant. However, the association and persons who may be aggrieved by its action shall be obliged to adduce all evidence that they deem relevant in the proceedings before the association, and no such person shall be entitled to adduce additional evidence unless he shows to the satisfaction of the Commission that such additional evidence is material and that there were reasonable grounds for his failure to adduce such evidence in the hearings before the association. Any

requests for leave to adduce additional evidence shall be filed promptly so as to not to delay the disposition of the proceeding.

NASD: RULES OF FAIR PRACTICE

ARTICLE III

RULES OF FAIR PRACTICE

SECTION 1. A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

SECTION 4. In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

REGULATION T

SECTION 4. SPECIAL ACCOUNTS

(*c*) SPECIAL CASH ACCOUNT.—

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

(8) Unless funds sufficient for the purpose are already in the account, no security other than an exempted security shall be purchased for, or sold to, any customer in a special cash account with the creditor if any security other than an exempted security has been purchased by such customer in such an account during the preceding 90 days, and then, for any reason whatever, without having been previously paid for in full by the customer, the security has been sold in the account or delivered out to any broker or dealer: *Provided,* That an appropriate committee of a national securities exchange or a national securities association, on application of the creditor, may authorize the creditor to disregard for the purposes of this subparagraph any given instance of the type therein described if the committee is satisfied that both creditor and customer are acting in good faith and that circumstances warrant such authorization. For the purposes of this subparagraph, the cancellation of a transaction, otherwise than to correct an error, shall be deemed to constitute a sale. The creditor may disregard for the purposes of this subparagraph a sale without prior payment provided full cash payment is received within the period described by subpara-

graph (2) of this paragraph and the customer has not withdrawn the proceeds of sale on or before the day on which such payment (and also final payment of any check received in that connection) is received. The creditor may so disregard a delivery of a security to another broker or dealer provided such delivery was for deposit into a special cash account which the latter broker or dealer maintains for the same customer and in which account there are already sufficient funds to pay for the security so purchased; and for the purpose of determininig in that connection the status of a customer's account at another broker or dealer, a creditor may rely upon a written statement which he accepts in good faith from such other broker or dealer.